

**STATE OF WISCONSIN
DEPARTMENT OF EMPLOYEE TRUST FUNDS
801 West Badger Road
Madison, WI 53702**

CORRESPONDENCE MEMORANDUM

DATE: October 24, 2002

TO: Deferred Compensation Board Members

FROM: Mary Willett, Director

SUBJECT: Excessive Trading in the International Equity Mutual Funds

Over the past several months, Barclays Global Investors (BGI) has brought to our attention a problem that has occurred in the EAFE Equity Index Fund that they manage for the Wisconsin Deferred Compensation Program (WDC). This fund, which is an international equity fund that is managed to track the Morgan Stanley Capital International - Europe, Australia, Far East (MSCI EAFE) Index, is under-performing the index because of heavy day trading activities by one or two WDC participants. To address this issue, staff is recommending the Deferred Compensation Board adopt a formal policy to prohibit this type of trading as it negatively affects the rest of the WDC participants who use this fund in their long-term retirement portfolio. This memo provides background on this issue and the proposed policy statement.

Background

WDC participants are allowed to execute exchanges between the available investment options on a daily basis (business days that the market is open). Exchange orders must be made by 3:00 p.m. Central Time to be effective with that day's closing price. The majority of WDC participants exchange their account balances infrequently. However, there are a few that are excessive traders, with some making several hundred exchanges a year.

This normally has no impact on the performance of the investment options that participants are exchanging into or out of. This, however, is not the case when excessive trading occurs in the international equity investment options. The reasons are as follow:

- Participants use the US equity markets as a leading indicator of the next day's behavior of the international markets.
- When a US market rally occurs, participants sell cash/US holdings to buy international options and in a down market the reverse happens (participants sell international and buy US); the expectation is that international markets will follow the US market up or down.
- When this occurs, the international fund is long on cash in a rising market, leveraged in declining markets (or the wrong side), which has a negative impact on fund performance.
- Actively trading in the international funds is financed at the expense of long-term participants.

In addition to the BGI fund, the WDC also offers participants the T Rowe Price International Stock Fund, which is an actively managed option. T Rowe Price has notified staff that this is a concern in all international stock funds and that they address this through their stated policy regarding excessive trading, which is located in their fund's prospectus. This policy states that during any 120-day period, participants may not exceed one buy-and-sell or sell-and-buy occurrence in any individual T Rowe Price Fund. This does not affect systematic transactions, such as payroll deferrals or scheduled periodic distributions. Although this is typically not enforced, T Rowe Price has begun imposing this restriction on certain defined contribution plans that have been experiencing excessive day trading activities in the international stock fund offerings.

In the WDC, this is occurring in the BGI EAFE Equity Index Fund, instead of the T Rowe Price International Stock Fund. This has an even greater impact on the BGI fund performance because the asset size of this fund is less than \$800 million. Participant assets that are frequently being exchanged into and out of this fund, typically by one participant, range between \$35,000 and \$50,000 per trade. Based on an attribution analysis prepared by the BGI fund portfolio manager, this gaming of exchanges has negatively affected fund performance by 38 basis points or .38% over the first three quarters of 2002.

BGI has asked the WDC to consider two alternative approaches to deal with this issue:

- 1) Impose a trade restriction of 90 days, where participants may not exceed one buy-and-sell or sell-and-buy occurrence in the BGI EAFE Equity Index Fund within this time period.
- 2) Impose a transaction fee on all trades into or out of this fund, with the fee deposited into the fund to offset the negative impact of the frequent buy and sell orders.

As a first step to address this issue, staff recommends that the Board establish a formal policy statement that sets the same trading restrictions on investments in the BGI fund that apply to the T Rowe Price International Equity Fund, per the fund's prospectus. This would allow the WDC to enforce the trading restriction on those participants who are abusing the flexibility to execute daily exchanges.

Proposed Policy Statement

To address the issue of excessive day trading in international equity WDC accounts, staff recommends that the Board adopt the following policy statement:

Frequent trades or market timing in your WDC account can disrupt management of a fund and raise its expenses. To prevent this activity, the Deferred Compensation Board has adopted an excessive trading policy. This policy allows you to make one purchase and one sale or one sale and one purchase involving the same fund within any 120-day period. If you exceed this limit or if you hold fund shares for less than 60 calendar days, you are in violation of our excessive trading policy. Systematic purchases and redemptions, which are payroll deferrals and scheduled periodic distributions, are exempt from this policy.

If the Board approves the above policy statement, staff will prepare an article for the 2002 fourth quarter newsletter informing participants of this action. In addition, any participant who has been identified as an excessive trader in the BGI EAFE Equity Fund will be sent a personal letter informing him or her of the Board's policy and how it will apply to any future trades.